PRIIPS FOR UCITS

October 2021

The PRIIPs story so far has been, if not long (it's less than five years old) then certainly arduous. Why? In short, the regime seeks to apply one set of rules to a broad and non-homogenous set of retail savings and investment products; a familiar issue for those currently grappling with the exigencies of SFDR.

However, in the case of PRIIPs, it's not only industry pushing for significant regime reform. Last summer, the European regulators (**ESA**) declined a request from the Commission to produce draft technical revisions addressing issues with the regime because, in the opinion of the ESAs, a *'comprehensive review'* and not a '*partial revision*' was necessary. The Commission only succeeded in extracting ESA-recommended revisions after agreeing to *'thoroughly examine the application of the PRIIPs framework'*. Making good on its promise, the Commission is currently progressing a *'holistic assessment'* of the PRIIPs regime, including a *'comprehensive analysis'* of issues *'related to the comparability'* of in-scope products, as part of its Retail Investment Strategy which is due in the first half of 2022.

Notwithstanding the various twists and turns in the story so far however, the scope of products required to produce a PRIIPs key information document (**KID**) is set to be expanded. 30 June 2022 is the proposed end-date of the PRIIPs KID exemption for managers and distributors of UCITS and other retail investment funds, as well as issuers of products with UCITS as underlying investment options. Although the exemption end-date has already been extended twice, it now appears that UCITS managers and distributors will become subject to PRIIPs rules from 1 July 2022 (this date was included in legislative amendments to PRIIPs adopted by the Commission on 7 September last).

New Level 2 Regulation: latest revisions to the PRIIPs Regime

On 7 September 2021, the Commission adopted revisions to the PRIIPs regime in the form of a revised Level 2 Regulation (**Level 2**) which is scheduled to take effect on 1 July 2022. Level 2, which broadly tracks the above-mentioned ESA-recommended revisions, builds various UCITS-specific rules into the PRIIPs regime with the aim of better facilitating the application of PRIIPs rules to UCITS from the end of the PRIIPs exemption for UCITS on 30 June 2022.

To coincide with the Level 2 effective date of 1 July 2022 and ensure UCITS are not subject to dual obligations under both PRIIPs and UCITS, proposals to turn off the UCITS KIID and switch on the PRIIPs KID for UCITS from 1 July 2022 have been issued. These so-called 'quick-fix' legislative proposals were recently the subject of brief industry consultations and final legislation formalising the switch is awaited (see here for further details).

For UCITS, the switch from UCITS KIID to PRIIPs KID is to be effected by way of an amendment to the UCITS regime which will allow for the publication of a PRIIPs KID in satisfaction of the UCITS KID rules.

The below summarises the timeline for the application of PRIIPs rules to UCITS:

1 January 2018	1 August 2019	7 September 2021	9 September 2021	31 December 2021	30 June 2022	1 July 2022
PRIIPs Level 1 & 2 in effect subject to UCITS and retail AIFs 2-year exemption	PRIIPs exemption for UCITS extended by further 2 years	Revised PRIIPs delegated regulation (including UCITS specific rules) adopted by Commission	End of consultations on: i. Further 6-month extension of PRIIPs exemption for UCITS & retail AIFs; and ii. UCITS Directive amendment to switch off UCITS KIID rules	Current (soon to be extended) PRIIPs exemption for UCITS & retail AIFs expires	Currently proposed end date of PRIIPs exemption for UCITS & retail AIFs	• Revised PRIIPs Delegated Regulation effective • UCITS & AIFs required to produce PRIIPs KID (under current proposal)

Imminent compliance challenges for UCITS managers

While UCITS managers have benefitted from a PRIIPs exemption since the regime's introduction in 2018, there are many who will have been indirectly impacted by PRIIPs rules or similar rules under MiFID II. UCITS managers with group or related entities that manage retail products in scope of the regime are likely all too aware of the compliance challenges in producing a PRIIPs KID. In addition, for many UCITS managers, the data needs of distributors and other PRIIPs' providers will have incentivised engagement in industry initiatives such as FinDatEx (Financial Data Exchange) and potentially led to the preparation and publication of a European PRIIPs Template or EPT (a revised version of which is currently under preparation to reflect Level 2). For these UCITS managers, leveraging experience of the regime to date will be crucial in preparing for the anticipated deadline of 1 July 2022. However, notwithstanding experience garnered to date and industry's data standardisation efforts, significant and imminent compliance challenges lie ahead for all UCITS managers.

Key PRIIPs issues for UCITS managers

Although similar in structure, in many respects the PRIIPs KID is fundamentally different from the UCITS key investor information document (**KIID**). Despite legislative efforts to resolve compliance issues for UCITS managers by incorporating UCITS-specific rules into the PRIIPs regime which draw heavily from the UCITS KIID rules, several key PRIIPs issues for UCITS remain:

1. **Performance**: the PRIIPs KID requires disclosure of both past performance and estimated future performance in four different scenarios. PRIIPs applies UCITS-specific rules for the disclosure of past performance which largely reflect corresponding UCITS KIID rules. There are also UCITS-specific PRIIPs rules for the calculation and disclosure of future performance scenarios.
2. **Summary risk indicator (SRI)**: unlike the UCITS KID SRRI, the SRI requires an aggregation of both market risk and credit risk indicators to produce an overall risk indicator.
3. **Reduction in Yield (RIY) cost indicator:** UCITS are required to use RIY to estimate the impact of costs on investor's return for different holding periods. Level 2 makes targeted amendments to the use and calculation of RIY to better align with MiFID cost disclosures.
4. **Transaction costs:** unlike the ongoing charge (OCF) calculation for UCITS KIIDs, the total aggregated cost figure in the PRIIPs KID includes transaction (implicit and explicit) costs calculated according to a prescribed methodology based on the average of 3 year's historical data.

In addition to the UCITS-specific PRIIPs rules for performance disclosures, PRIIPs includes adapted versions of the UCITS KIID rules for umbrellas, share classes, fund of funds, feeder funds and structured UCITS. UCITS managers will be familiar with the requirements and facilitations under these rules although notably, they retain the ability for UCITS to publish a representative share class KID as well as the requirement to produce a KID for individual sub-funds. The rules for the 'What is this product' section of the PRIIPs KID include adapted versions of the existing UCITS KIID rules for the investment objective and policies section of the UCITS KIID.

Notwithstanding the recent adoption of UCITS-specific PRIIPs rules however, UCITS managers will undoubtedly face significant compliance challenges following the end of the PRIIPs exemption for UCITS and further consideration of the above highlighted issues is set out below.

1. Performance

PRIIPs requires UCITS managers to disclose both future performance scenarios and a link to published past performance.

Past performance

Acknowledging the strong arguments from both industry and the ESA, PRIIPs provides for the disclosure of past performance in the PRIIPs KID for UCITS. To avoid elongating the KID beyond the current 3-page maximum however, UCITS are required to include a link to a website or separate past performance document in the final section of the PRIIPs KID on 'other relevant information'. The calculation and presentation of past performance is prescribed under PRIIPs rules which materially track the existing UCITS KIID rules although notably, the PRIIPs rules specifically reflect the ESMA closet-indexing Q&As and the requirements for the past performance bar chart where the UCITS is managed 'in reference to a benchmark'.

Future performance scenarios

Despite unrealistic expectation concerns, the disclosure of future performance scenarios in the PRIIPs KID is retained for UCITS. However, the methodologies for UCITS calculating future performance scenarios have been substantially revised under Level 2. The simulated model-based methodologies for estimating three of the four future performance scenarios i.e. the favourable, unfavourable and moderate scenarios have been replaced by simpler and more factual methodologies that provide for the use of direct estimates based on the distribution of UCITS returns over the previous 10 years. Under the revised methodologies, for example, the favourable, moderate and unfavourable scenarios reflect the evolution of the best, average and worst returns recorded over the last 10 years. If 10 years of data is unavailable, historical data should be supplemented with reference, representative or proxy benchmark data. The model-based methodology for the stress scenario remains largely unchanged other than a new specification that the stress scenario value must not be better than the unfavourable scenario value.

2. Summary Risk Indicator

*PRIIPs requires UCITS managers to calculate and disclose a summary risk indicator (**SRI**) as an indicator of the risks and rewards of investing in the UCITS.*

The disclosure rules for the SRI and its underlying calculation methodology remain largely unchanged under Level 2. However, to address industry concerns about the potential for the SRI to understate risk, UCITS managers are permitted to increase the SRI if it does not adequately reflect the risk of investing in the UCITS. The potential for understating risk was a key issue for UCITS managers as in many instances, due to the very different calculation methodology for the SRI when compared to the SRRI, the classification of risk under PRIIPs was lower than under UCITS rules and so Level 2 seeks to address concerns of investor misinterpretation of a lower risk number in the PRIIPs KID than the SRRI currently disclosed in the UCITS KIID by allowing discretionary increases of the SRI.

3. Reduction in Yield (RIY) cost indicator

PRIIPs requires UCITS managers to disclose a summary cost indicator (using RIY) reflecting the impact of total costs on investors return for different holding periods and a breakdown by cost component (entry/exit, transaction, service provider/operational and performance)

While RIY has been retained, its use in the KID cost breakdown table has been replaced and targeted amendments have been made to its calculation as a summary cost indicator for UCITS. In the cost breakdown table, UCITS must instead show monetary costs after one year assuming zero net performance and an investment of €10k. When calculating the summary cost indicator for the KID total costs table, UCITS should also assume zero net performance in the first year before reverting to performance assumptions based on the 'moderate' scenario when disclosing for any subsequent holding periods. Assumptions based on net zero performance better align with the MiFID cost disclosure rules however, their use for further periods was excluded for potentially underestimating monetary cost amounts.

The number of holding periods for which a summary indicator is required in the total costs table has also been amended so that only UCITS with a recommended holding period of 10 years or more must disclose for a third holding period i.e. at half the recommended holding period. All other UCITS must disclose total costs and their impact at the end of the recommended holding period and, if the recommended holding period is longer than 1 year, after a one-year holding period.

4. Transaction costs

Unlike the UCITS KIID OCF, transaction costs are specifically included in the calculation of total costs under PRIIPs and the impact of transaction costs after one year must be included in the KID cost breakdown table

Subject to certain exemptions and limited amendments, the controversial 'slippage' methodology is retained for calculating transaction costs. Under PRIIPs rules, transaction costs include both implicit (included in the price) and explicit (commission and tax) costs. The slippage method, which must be applied for transactions in liquid assets by PRIIPs that have been operating for more than three years, requires the price actually paid to be compared to the market (arrival) price at the time of the trade with the aim of capturing both bid-ask spread and market impact as implicit costs of the transaction.

Many in industry have argued the inappropriateness of the slippage method as, inconsistent with other EU regimes (e.g. MiFID), it attributes market movements between order transmission and execution as a cost to investors. In response, the ESA say the method's aggregation of multiple transactions serve to eliminate the impact of market movements and on this basis the method has been retained. However, in line with the ESA rationale, an exemption to the use of slippage is now permitted for UCITS with an insufficient level of transactions to ensure elimination of market movements on the basis of aggregation. A temporary exemption to the use of slippage has also been included which allows UCITS, following the end of the exemption on 30 June 2022, an 18-month transitional period (up to 31 December 2024) during which they may calculate transaction costs using the method for newly established PRIIPs (based on a 'half-spread measure'). An exemption is also included for the calculation of transaction costs of over-the-counter trades, e.g. bonds and derivatives, which again provides for the use of a half-spread measure instead of the slippage method.

As well as these exemptions to the use of slippage, the methodology itself has been adjusted and now includes a transaction cost floor which requires disclosure of a minimum level of aggregate explicit costs based on the previous three year's transactions and which should apply if reducing transaction costs with proceeds of anti-dilution measures. The inclusion of a cost floor is designed to address the issue of a negative transaction result under the slippage method (a key issue that many believe argues for its removal from the regime) and the likelihood of investors misinterpreting such a result.

Next steps

Revisions to the PRIIPs Level 2 Regulation, while adopted by the Commission, must now undergo the final stages of the EU legislative process before entering into force on the currently slated effective date of 1 July 2022. The proposed end-date of the PRIIPs exemption for UCITS of 30 June 2022 will only be finalised following the adoption of amendments to the PRIIPs regime. These are expected imminently after the industry consultation on the amendments concluded at the beginning of September last. Finalised amendments to the UCITS regime to switch off the UCITS KIID are also expected in the near term. As things stand, upon finalisation of all three legislative measures (PRIIPs Level 1 and 2 amendments and UCITS amendments) UCITS managers will have until 1 July 2022 to produce a PRIIPs KID in line with Level 2 and instead of the UCITS KIID.